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National City Monthly Letter on Business and Economic Conditions

New York, February, 1955

General Business Conditions

THE new year is off to a good start, with business in some quarters showing more strength than even the optimists had expected. The most striking report made during January comes from the Department of Commerce, which estimates that December retail sales totaled $18 billion, more than a billion dollars greater than any previous month on record. Post-Christmas volume also has been exceptionally good. In the first three weeks of January department store sales averaged 10 per cent above a year ago, and reports from other retailers including automobile dealers leave little doubt that total consumer purchases during the month have broken all January records.

Passenger automobile sales, estimated at 570,000 cars in December, have contributed heavily to the good showing. Seldom if ever have new automobile models been met with such a rush of buying. The big business is attributable not only to new designs and improvements, and to high consumer buying power, but to an unprecedented sales effort, including widespread price discounts given by dealers to keep abreast of competition and stimulate volume.

Optimistic forecasts for 1955 were the rule at the year-end, and the forecasters placed their chief reliance upon expanding consumer demand rather than upon business spending. As far as they go, the figures of recent weeks suggest that this reliance is not misplaced. In the end the controlling influences upon consumer purchases will be found in the figures of employment, hours worked, and consumer income; and indications are that jobs and wage payments will continue to increase in the next few months, except where the seasonally low level of outdoor work is a factor. The Federal Reserve Board's seasonally adjusted index of industrial production advanced to 130 in December (1947-49 = 100). At that point it had recovered half of the loss from the 1953 peak of 137 to the 1954 low of 123. Probably it rose a little further in January. In the months just ahead, seasonal improvement in industrial output is expected.

Steel and Autos Lead Upswing

The steel and automobile industries have been consistently accounting for the lion's share of production gains. In mid-January steel ingot output was exceeding 2 million tons a week, and automobile assembly lines were turning out a near record of 163,000 passenger cars a week. By all signs these industries will be running strongly during the next three months at least. The purchasing power created, directly and indirectly, by their demands for labor, materials, and services will flow around the circle.

In other lines the improvement already realized is being held or moderately extended. Construction activity is giving greater support to general business than ever before. The textiles and many of the other non-durable goods in-

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dustries, which had a good upturn in the fourth quarter of 1954, entered 1955 in a good position. Activity in consumers' durable goods other than automobiles, after a marked recovery, seems to have stabilized at the higher level. Output of producers' equipment and military goods has been stable since early fall when the decline levelled off. Even the machine tool industry, which is expected to be one of the laggards in 1955, reported increased sales in December and January.

Business sentiment clearly is good. Business leadership continues to show a willingness to back its optimism with programs of capital investment, and scattered indications of upward revision of earlier plans are observed. To some extent rebuilding of inventories seems to have begun in November, when seasonally adjusted inventory figures showed a moderate rise. This ended a continuous decline that had lasted thirteen months and had reduced stocks by $4.4 billion or 5½ per cent. Little disposition to anticipate scarcities or higher prices is seen, but as business improves many lines find larger stocks necessary, and as delivery dates lengthen commitments must be extended.

How Much More Improvement?

With reports of this kind, the predictions that 1955 will be a better year than 1954 now seem to have a secure basis, and are accepted almost everywhere. In judging how much further the rise has to go, two reasons for moderation appear. One is that the improvement has already been substantial; the 1955 upswing, instead of being wholly in the future, has already occurred to a considerable extent. The recovery, within about four months, of one-half of the ground lost during the recession, is an impressive performance. It has come about wholly through private demand since government purchases of goods and services, currently at an annual rate around $74 billion against the 1953 high point of $86.6 billions, were still declining at the year-end.

The second reason for moderation is that the recovery has been so heavily influenced by the automobile and steel industries, and must be expected to slow down unless operations expand further in a wider variety of industries. Automobile output eventually must slacken. It may be curtailed by strikes, if the union demands for a guaranteed annual wage are pushed that far; otherwise, it will be curtailed by overstocking of dealers, since no one expects that a production equivalent to 8,000,000 passenger cars a year can be absorbed. Steel operating rates will be influenced by automobile requirements. These two industries account directly for almost 10 per cent of the industrial output of the country. A summer let-up, exceeding the usual seasonal dimensions, is a reasonable expectation.

In construction, builders' plans promise an active spring. In the last five months of 1954 residential construction contract awards reported by the F. W. Dodge Corporation ran nearly 50 per cent above the corresponding 1953 figures. In the first 22 days of January the gain over a year earlier was 29 per cent. The boom in home building and the development of suburban areas carries with it a great increase in construction of shopping centers, public utilities, schools, roads, hospitals and churches, to say nothing of household equipment and furnishings.

But in construction, as in other lines mentioned, there is a question as to how much improvement, other than seasonal, can be expected on top of the levels already reached. Government agencies estimate total construction expenditures in 1955 at $39.5 billion, a substantial increase over the $37.2 billion recorded in 1954 which in turn compared with $35.3 billion in 1953. However, the expected 1955 level was almost achieved in December, when on a seasonally adjusted basis the annual rate reached $39.1 billion. Approximately the same relationships are shown in the figures of housing starts. A total of 1,215,000 new homes were started in 1954, up from 1,104,000 in 1953 and second only to the 1950 record. December starts, seasonally adjusted, were at the rate of 1,473,000 per year. To hold this rate through 1955 would be a phenomenal performance.

Expansion Becomes Cumulative

Since a broader industrial and trade advance will be required to carry the recovery beyond the summer, the outlook for the second half-year may turn not only on consumer demand, but on business spending as well. As order volumes increase, a tendency to take off the shelf plans which have been held in abeyance frequently appears. We have already referred to scattered indications of this kind, and to what is seemingly the end of inventory liquidation. Both of these illustrate the cumulative nature of recovery, in which each line of production and trade gives support to other lines and the whole stimulates an increase in investment and building up of stocks that cannot always be foreseen when the recovery starts. Such cumulative influences operate to carry on the upward movement.

The degree to which inventory replenishment is carried will have a great deal to do with the level of business in the coming months. It is also the most incalculable influence in the outlook. A general spread of forward buying would lift the business figures and prolong the rise. For the long run, however, it would also present hazards. Experience has shown that a rapid and general rise in inventories tends to go to excess, and usually proves to be an element of instability. Fortunately, fear of scarcities is playing little if any part in the improvement in buying. Copper comes nearer to being a scarce commodity than any other major industrial material, but strikes in this country and Chile last year, and in Rhodesia currently, are largely responsible. Given labor peace, and with the expansion plans under way, the tightness will ease in due course.

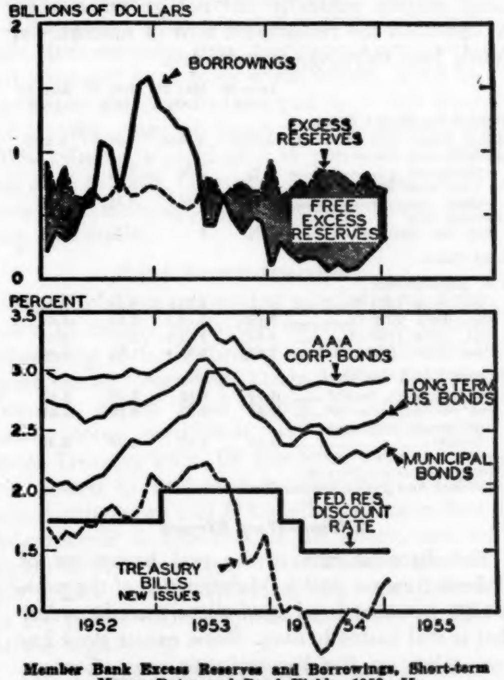
Meanwhile recovery is promoted by success in attracting consumer demand, by offering new and better things, pricing them competitively, and selling them effectively. This is the sound way of expanding trade and realizing the economy's potential for growth. It provides a solid basis for continuing recovery and real prosperity, in contrast to the weaknesses that must eventually appear if the construction boom is carried to excess or inventory accumulation is over-stimulated.

Credit Policy Shifts

The accelerating tendencies of the construction boom, the vigorous rise of production and trade, mounting optimism of the business community, and sporadic evidences of speculative enthusiasm, led the Federal Reserve authorities during January to moderate their policy of "active ease." This policy, set in force to prevent the 1953-54 recession from spiralling into a real depression, has saturated the credit structure with loanable funds, put lenders under pressure to seek out ways to employ them, and generally invited borrowing to spend. It has taken hold. The abundance of money is being drawn into use. If too much is drawn into use the economy will spin off into a round of credit and price inflation.

The increase in stock margin requirements, ordered by the Federal Reserve Board on January 4, while affecting what is today a comparatively minor area of credit usage, served the purpose of reminding people that unbridled optimism can be as dangerous as unbridled pessimism. Of broader significance, the authorities in following weeks acted to pare down the surplus loan funds introduced into the banking system last year to assist trade revival. Since January is a month when idle funds are accumulating in the banks from the post-Christmas return flow of currency from circulation, this required the Federal Reserve to undertake exceptionally heavy sales of Treasury bills in the open market. These sales ran to $929 million between January 5 and 19 and to $1,277 million for the four weeks ended January 26. Sales of bills to mop up the January return flow of currency averaged $1 billion in 1952-54.

As the chart shows, excess reserves of the member banks of the Federal Reserve System, which were maintained at an average of $770 million last year, were held below $700 million in January, and banks did more borrowing from the Federal Reserve than they had since December 1953. "Free" excess reserves — the difference between excess reserves and borrowings — averaged less than $400 million in January against a $630 million average in 1954.



Member Bank Excess Reserves and Borrowings, Short-term Money Rates and Bond Yields, 1952 - 55 (Monthly Plottings of Daily or Weekly Averages)

As is generally true when banks are borrowing from the Federal Reserve in considerable amounts, the rate paid for overnight loans among banks, so-called "Federal funds" transactions, rarely dropped much below the 1½ per cent Federal Reserve discount rate. Yields on 91-day Treasury bills, which were below 1 per cent as

recently as November, fluctuated in a range of 1⅛ to 1⅜ per cent. Open market rates on bankers' acceptances, commercial paper and finance company paper were advanced ⅛ or ¼ per cent from the extreme low levels previously prevailing. Treasury bond prices moved lower, influenced by rumors that the discount rate might be advanced, anticipations that the Treasury might make a long-term bond offering, efforts by bond dealers to cut back their inventories, portfolio adjustments by banks in expectation of more active business loan requirements, and the swollen demands of the mortgage market.

U.S. bonds, which for some months had been edging down from their July 1954 peaks, declined ½ to 3 points further in January, raising yields to the buyer ¼ to ⅜ per cent above the lows of last July. As the table shows, yields on state and local government bonds also tended to increase. The higher grades of corporate bonds, enjoying strong demands from pension funds, held comparatively steady. The movement in the bond market evidently did not go far enough to constrain the remarkable flow of institutional funds into mortgage investments.

	June 30 1952	May 31 1953	July 31 1954	Jan. 31 1955
Short-Term Money Rates				
91-day Treas. bills, new iss.	1.68%	2.08%	0.80%	1.35%
90-day prime bankers' acceptances	1¾	1⅞	1¼	1⅝
3-6 mos. sales finance co. paper	2⅜	2½	1¼	1½
Discount rate Fed. Res. Bank of N. Y.	1¾	2	1½	1½
Bond Yields				
U.S. Governments				
3¼s, June 1978-83	—	3.28	2.59	2.81
2½s, Dec. 1967-72	2.62	3.12	2.44	2.69
2¼s, June 1959-62	2.32	3.17	2.01	2.40
2⅜s, June 1958	2.27	3.08	1.63	2.02
Corporate and Municipal				
Aaa corporate bonds*	2.94	3.35	2.88	2.95
Baa corporate bonds*	3.50	3.80	3.51	3.46
High grade municipal bonds†	2.12	2.77	2.26	2.41

* Moody's Investors Service.
† Standard and Poor's Corporation.

A Two-Way Street

The discount rate is the real barometer of Federal Reserve policy. Maintenance of the present 1½ per cent level symbolizes a credit policy that is still basically easy. Some excess slack has been taken up, the discount rate made effective, and borrowers and lenders reminded that credit policy is a two-way street.

The recovery in production and trade from the 1954 recession has not yet developed more than symptomatic price advances. But what Federal Reserve policy seems to be saying is that the current upsurge contains the seeds of another general round of cost, price and credit inflation; that mild treatments, given in a timely fashion, may prevent the disease.

Some people had gained the impression, from the extremes to which the easy money policy was carried last year, that the authorities, smarting under criticism for having choked off the 1953 boom with a "hard money" policy, had lost their zeal for protecting the value of the dollar and were adopting an indulgent view toward a renewal of the inflationary process. The Federal Reserve's actions in January cast doubts upon this interpretation.

In Europe, where business is booming, a number of nations are acting to combat renewed inflation by checking monetary expansion, letting money rates rise, and shifting public debt out of the banks. On January 27 the Bank of England raised its discount rate from 3 to 3½ per cent as a curb on boom psychology. It is reassuring to note that public officials here are watching the situation very closely. Speaking at the mid-winter meeting of the New York State Bankers Association on January 24, Allan Sproul, President of the Federal Reserve Bank of New York, explained current Federal Reserve policy in the following terms:

> The economy is now in a strong recovery from the recent recession. What the System is doing is treading a narrow path between providing enough credit for the real needs of an expanding economy without providing too many reserves which would increase inflationary pressures.

Interviewed by the magazine, *U.S. News and World Report* three weeks ago, Secretary of the Treasury George M. Humphrey set the problem in clear focus:

> It is very easy just to sit back and relax and let things happen that can lead to inflation. It is much tougher to have the courage to take the steps that are necessary to prevent it from developing. Unnecessary Government spending, inadequate or improper taxation, or excessive credit expansion could again lead to inflationary pressures if we are not constantly alert. . . .
>
> You might say that two basic things are needed. First of all, we have to keep our fiscal operations on a sound basis and keep working toward a balanced budget at the lowest levels of taxation consistent with our defense needs. On top of that, we have to be sure that our monetary and debt management policies continue to be directed along that narrow road between inflation and deflation. In that way we can continue to work for the stability of the dollar and provide a sound basis for economic growth.

The President took the occasion in his annual budget message to restate his determination to preserve monetary stability:

> This administration has made a stable dollar and economy in government operations positive policies from the top down. Expenditure reductions, together with a judicious tax program, effective monetary policy, and

careful management of the public debt, will help to assure a stable cost-of-living — continuing our achievement of the past two years.

Treasury Refunding

The Secretary of the Treasury on January 28 revealed the plans for handling the $15 billion of February and March Treasury maturities. Holders of $7,007 million 1⅝ per cent certificates of indebtedness due February 15 and $5,365 million 1½ per cent notes due March 15 are being offered a choice between new 1⅝ per cent thirteen-months' notes due March 15, 1956 and new 2 per cent two and one-half year notes due August 15, 1957. Holders of the $2,611 million 2⅞ per cent partially tax exempt bonds called for payment March 15 will be offered a choice between the new thirteen-months' notes and 3 per cent forty-year bonds due February 15, 1995. Subscription books will be open for exchange subscriptions February 1-3. All the new securities will be dated February 15 and the exchanges will be carried out on that date.

The Treasury program was well received in the market. The maturing certificates and notes commanded premiums of about $\frac{1}{16}$ point on January 31; the maturing bonds held a premium of $\frac{5}{16}$ point. The new offerings were priced to appeal to a market that had less slack than in 1954 and that was finding better opportunities in other investments and loans. The 1⅝ per cent rate placed on the new thirteen-months' notes was ½ per cent higher than had been offered on one-year certificates in May and August 1954 though a full 1 per cent below the one-year borrowing rate required in May, August and September of 1953. The 2 per cent rate on the two and one-half year notes compares with 1⅝ per cent paid on an issue of two-year seven-months' notes last October, 1⅞ per cent paid on a four-year nine-months' issue last May, and 2⅞ per cent on a three-year six-months' issue in September of 1953.

New Forty-Year Bonds

The offer of forty-year 3s will be a minor element in the $15 billion refinancing since it will be limited by the $2.6 billion dimensions of the maturing 2⅞s as well as by the strength of competing investment opportunities. Nevertheless, the new bond was of particular interest since it represents only the second long-term Treasury bond offering since World War II. The earlier issue, the $1.6 billion of thirty-year 3¼s, was put out under adverse market conditions in May of 1953. Reacting to diminished credit demands, and successive moves of the Federal Reserve to create a superabundance of credit supply, these bonds moved up as high as 112 last summer to yield a buyer less than 2⅝ per cent. At that time the Treasury might have been able to tap the long-term market at a 2¾ per cent rate. The opportunity was passed up, quite deliberately, in order not to compete with the increasing flows of funds into mortgages and state and local government bonds which were financing enlarged construction activity. The decision to go ahead with a long-term offering now is evidently predicated on the belief that further acceleration of the construction boom is not needed to support employment opportunities and may, as a matter of fact, threaten to recreate conditions of labor shortage and the rising prices that go with an overtime economy.

Even with the absence of further long-term Treasury offerings, the thirty-year 3¼s found a natural turning point in the market about six months ago. As their price rose pension fund buyers shifted their interest to other investments, mainly corporate stocks and bonds. Holders of U.S. obligations were tempted to take profits and shift, for example, into mortgage investments and state and local government bonds. Thus by December the 3¼s had slipped to a 110 level and at the close of January were quoted at 107⅜, offering a yield of 2.81 per cent to first call date in 1978. The new 3s are expected to have their main appeal for pension funds, private and public.

Debt Reconstruction

The $15 billion refinancing scheduled for February 15 closely rivals the massive $18 billion refinancing of last February and the $17 billion operation of December. During all of 1954 the Treasury issued $62.2 billion of marketable bonds, notes, certificates and tax anticipation series Treasury bills. Of this total, $49.6 billion was issued in exchange for maturing or converted obligations and $12.6 billion to cover debt redemptions, to take care of the deficit, and to replenish cash balances. In addition, a total of $78 billion 91-day Treasury bills were issued in the course of rolling over maturities of $1½ billion each week.

The Treasury, having passed the 1954 concentration of maturities, is now beginning to reap the first fruits of its debt reconstruction efforts. No action has been taken up to the present to cut back the proportions of the weekly Treasury bill maturities, but, omitting these and tax anticipation borrowings, the total of marketable certificate, note and bond maturities demanding attention will be $39.6 billion in

1955 against $50.5 billion in 1954. After the February 15 exchange is completed, the Treasury will have only three major blocks of maturities to cover with exchange offers during 1955: $3.9 billion on May 17, $8.5 billion on August 15, and $12.2 billion on December 15.

Reconstructing a $275 billion public debt necessarily must be a slow and gradual process. The build-up in short-term debt since World War II reflects the Treasury policy in the early post-war years of issuing only securities of short-term or giving privileges of cash redemption at the option of the holder. Despite the Treasury's tentative debt lengthening efforts in 1952-53, almost 81 per cent of the interest-bearing debt on December 31, 1953 was due or redeemable at the option of the holder within five years. During 1954 the Treasury, as noted, avoided the long-term market, but shifted $13 billion of the debt out into the five-to-ten year maturity range. The proportion of the debt falling due within five years was reduced to 76 per cent of the total.

The abstention of the Treasury from the long-term market resulted in the complete disappearance, by December 31, 1952, of bonds over 20 years to maturity. The $1.6 billion issue of 30-year 3¼s, put out in 1953, is all there is at the moment of truly long-term funded debt. The forty-year 3s will add moderately to this total.

The forty-year term distinguishes the new bonds as the longest the Treasury has offered since the fifty-year Panama Canal 3s put out in 1911. Unlike the new 3s, which are fully taxable, the Panama Canal 3s were exempted from income tax.

Basic Principles

Treasury Secretary Humphrey summed up the principles of debt management currently being pursued in a statement two months ago to Senator Flanders' subcommittee inquiring into monetary and debt management policies:

> The principles we have been following in the management of the large public debt are not new. They are, likewise, principles that have been laid down by your predecessor subcommittees after extensive study and careful consideration of the fundamental role they can play in effective monetary policy.
>
> The first principle is that monetary and debt management policies should be flexible. To be effective they must lean against inflation as well as deflation. As put by the Douglas subcommittee and reaffirmed by the Patman subcommittee, and I quote once more: "Timely flexibility toward easy credit at some times and credit restriction at other times is an essential characteristic of a monetary policy that will promote economic stability rather than instability."
>
> The second principle is that Treasury debt management operations should be consistent with current monetary and credit control policies of the Federal Reserve. This means close cooperation at all times between the Federal Reserve and the Treasury. . . .
>
> This administration has followed these principles because we believe them to be fundamental principles of good government. We believe the record of the past two years has indicated their effectiveness in giving us honest money and laying a firm foundation for the sound growth and prosperity of our country.

Progress Toward a Balanced Budget

President Eisenhower's budget of the U.S. Government for the fiscal year 1956, submitted to the Congress last month, indicates a reduction in estimated expenditures as compared with the current fiscal year '55 and an increase in receipts, both of which contribute toward a cut in the expected deficit. Total spending in the year ended June 30, 1956 is put at approximately $62.4 billion, down $1.1 billion from the estimated total of $63.5 billion in the current fiscal year. It would be $5 billion below the total spent in fiscal '54, and $15 billion below the spending for that year proposed by former President Truman just before leaving office.

The curtailment of government outlays has been accompanied by substantial relief granted to taxpayers through lowering of tax rates combined with comprehensive revision of the internal revenue laws. Net receipts in fiscal '56 are estimated at $60 billion. This is $1 billion above the total in the current year, due to an expected rise in business turnover and in corporate and individual incomes. It is, however, more than $4 billion lower than actual collections in fiscal '54 and $8 billion lower than the original budget estimate.

The indicated fiscal '56 deficit is $2.4 billion. This represents a sharp cut from the estimated $4.5 billion deficit this year, and contrasts with a deficit originally projected at $9.9 billion for fiscal '54. As the President states in his message to Congress presenting the latest annual figures, "Thus we continue to progress toward a balanced budget."

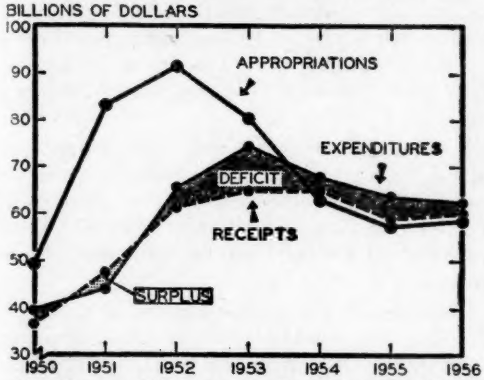
U.S. Government Budget Summary for Fiscal Years, 1950 - 56

(In Billions of Dollars)

June 30	Appropriations	Expenditures	Net Receipts	Surplus or Deficit	Public Debt
1950	$49.3	$39.6	$36.5	$—3.1	$257.4
1951	82.9	44.1	47.6	+3.5	255.2
1952	91.4	65.4	61.4	—4.0	259.1
1953	80.3	74.3	64.8	—9.4	266.1
1954	62.8	67.8	64.7	—3.1	271.3
1955 Est.	57.2	63.5	59.0	—4.5	274.3
1956 Est.	58.6	62.4	60.0	—2.4	276.0

A summary of the over-all budget trends since fiscal '50, before the war in Korea, is given in the accompanying table and chart. These show, in addition to expenditures, the annual totals

of appropriations or authority to spend. Such appropriations for the 1951 and 1952 fiscal years far exceeded the needs for current expenditure. Thus unused spending authority was built up and carried forward. By June 30, 1952 the total of current and accumulated appropriations exceeded $91 billion, or $26 billion in excess of actual expenditures. Close control of the budget by Congress was rendered impossible.



U.S. Government Net Receipts, Expenditures, Deficit, and Appropriations (New Obligational Authority) by Fiscal Years. Figures for 1955 and 1956 Estimated.

During the past two years the Administration and Congress, to regain a better control, have slashed appropriations below the reduced levels of expenditures. The fiscal '56 budget calls for an upturn of $1.3 billion in new appropriations, although the total still will be $4 billion below scheduled expenditures.

Broad Policy

In framing the budget for the fiscal year 1956, President Eisenhower stated in his message that he had been guided by three broad considerations of national policy:

> First, we must defend our priceless heritage of political liberty and personal freedom against attack from without and undermining from within. Our efforts to date have helped bring about encouraging results — cessation of fighting, new and stronger alliances, and some lessening of tensions. . . .
>
> Second, the Government must do its part to advance human welfare and encourage economic growth with constructive actions, but only where our people cannot take the necessary actions for themselves. As far as possible, these steps should be taken in partnership with State and local government and private enterprise. . . .
>
> Third, we must maintain financial strength. Preserving the value of the dollar is a matter of vital concern to each of us. Surely no one would advocate a special tax on the widows and orphans, pensioners, and working people with fixed incomes. Yet inflation acts like a tax which hits these groups hardest. . . .

To the above considerations the President added that this budget had been shaped by "a liberal attitude toward the welfare of people and a conservative approach to the use of their money."

In the practical application of these broad principles of budget policy the Government now faces two major difficulties. First is that of making much further reduction in expenditures from now on. Of the $12 billion cut in total spending between the peak in fiscal '53 and the year '56, $10 billion came out of the national defense budget. World tensions forbid radical pruning of outlays in this category, which accounts for two-thirds of programmed expenditures. Spending for other than defense purposes was reduced during that period by only $2 billion, half of which was in foreign aid outlays. It is becoming harder and harder to find ways to pare down the non-defense total from its present $22 billion level.

Getting Taxes Down

The second major budget difficulty arises from the need to keep revenues high in order to reduce or eliminate the deficit, yet at the same time to make headway toward correcting excessive tax rates. The trend has been to recognize tax hardships by special provisions to ease the problems of one particular group or another of the population. This approach piles complication on complication in the filing of returns, adding to costs of administration, cluttering up the courts with tax cases, and creating a situation where even the recognized tax expert must plead to ignorance on particular areas of the law. Instead of singling out group after group to a point where almost everyone has benefits designed especially for him, the focus should be placed on easing the rates and universalizing such reliefs as can be afforded.

The real trouble is that taxes generally are too high and that inequities which may be tolerable at reasonable levels of taxation become intolerable at such high levels.

President Eisenhower recommended, in view of the $2.4 billion budget deficit for fiscal '56 expected on the basis of existing tax rates, that Congress cancel the decreases in corporate income tax rates and certain excise taxes that under present law would otherwise go into effect on April 1st. These decreases, which already have been postponed for one year by act of Congress last spring, involve a revenue loss estimated at $2 billion for a full year. The President warns that any other course of action would result in either (1) inadequate expenditures for national security, or (2) inflationary borrowing.

The President, however, holds out the hope for some tax relief in the calendar year 1956.

"The present take", he declares, "of nearly one-fourth of our national income is a serious obstacle to the long-term dynamic growth of the economy which is so necessary for the future." Continuing, he states:

. . . further tax reduction remains a firm goal of this administration, and our policy is directed to achieving both the savings in expenditures and the economic growth that will make such reductions possible.

To achieve this goal will call for even more constant hammering than in the past at non-essential expenditures. It will entail not only the reduction of waste and inefficiency wherever it is discovered in the national defense organization and throughout other departments and agencies, but also the elimination of those entire functions that the Federal Government does not really need to carry on or that private enterprise could do better. All this can be accomplished only by determined action of Congress and active support from the electorate.

400 in the "Industrial Average"

Action in December of the widely-publicized Dow-Jones average of industrial stock prices in breaking through its old 1929 high of 381 and then going over the 400 mark, followed in quick succession by the raising of stock exchange margin requirements by the Federal Reserve and by the voting of an investigation or "study" of the market's behavior by the Senate Banking and Currency Committee under Senator Fulbright, has resurrected the stock market from the financial section and made it front page news.

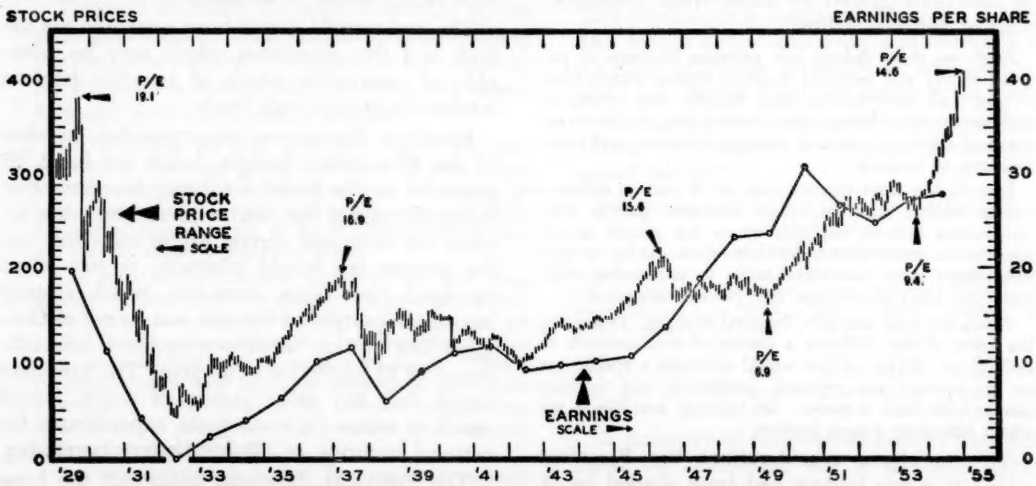
The rapid rise in the market over the past year, and particularly since Election Day last November, has been a topic of growing interest. It has raised a host of questions bearing on security values and on the American economy in general. People worry that prices may be getting "too high". They fear the market may be off on another speculative spree, leading to a crash. The developments of the past three months have sharpened these questions and set more people thinking about them. Inevitably, the publicity given to the Dow-Jones industrial average surpassing its 1929 peak has raised some uneasy wondering as to how far conditions today may be analogous to those twenty-five years ago.

Because the stock market is important not only for such indications as it may give of the state of business, but also for the influence it may have in shaping the trend of business, some comment on the market situation appears to be in order.

Two tests of the market commonly used are: (1) from the standpoint of comparative prices and values, and (2) from the standpoint of credit involved.

The Test of Values

As to (1), mere comparisons of present stock prices, whether with '29 or some other period, are not in themselves very meaningful. Nor do figures often cited of the growth of national income, savings, money supply, etc., or dilution of the value of the dollar, appear wholly relevant in appraising stock quotations. The bare fact that the economy has grown bigger, or that the dollar has depreciated in terms of many things, does not in itself guarantee that stock prices will



Monthly High and Low Dow-Jones Industrial Stock Price Index, Annual Earnings per Share, and Price/Earnings Ratios at Selected Points

be higher. What counts, rather, is the amount of earning power and asset value behind each individual stock, and income return compared with alternative investments; also such intangibles as the degree of investor confidence both in the general economic climate and in the prospects for the particular company.

With such criteria in mind we present the accompanying chart and table comparing the Dow-Jones industrial averages with earnings, book values, and dividends per share of the component companies from '29 to date.

We use this index because it is the one most commonly followed and for which data are most readily available. Admittedly, it leaves much to be desired as a measure of the general market. Composed as it is of 30 leading industrial stocks, this index is more representative of a limited group of "blue chips" than of the general run of shares. Even among these there are wide variations.

Moreover, the index today is not composed of precisely the same stocks as in 1929. Some issues have been dropped out along the way and others substituted. Obviously, these shifts in makeup have impaired the long-range comparability of this index. Probably, however, the ratios of prices to earnings, book values, and dividends have been less affected than prices alone. In any event, since 1939 the list has been identical.

Finally it must be borne in mind that even ratios of stock prices to reported earnings and book values can never be wholly reliable guides, due to accounting regulations and practices – particularly in such matters as the rates of depreciation charged against earnings and asset valuations.

What the Ratios Show

With these words of explanation and caution, we turn to the chart and table. Two things stand out particularly:

1. Taking the 25-year period as a whole, prices have tended to fluctuate in a broad sort of way with earnings, book values, and dividends. At times prices have tended to run ahead of the procession, at other times to lag behind.

2. While prices have advanced greatly during the postwar period, so too have earnings, assets, and dividends. Since the 1942 low, when the Dow-Jones industrial average stood at approximately 93 (as against the recent peak of 409), earnings of these companies have trebled from around $9 to an estimated $28 (1954) per share, book values have more than doubled from around $109 to an estimated $235 per share, and dividends have almost trebled from $6.40 to $17.47 per share.

Certainly, no one can judge the present market without taking account of this great increase in basic values.

What all this means in terms of ratios of prices to earnings, book values, and dividends is indicated at selected points. It will be seen that at the January '55 peak of the market the Dow-Jones industrials were selling at close to 14½ times estimated '54 earnings, at 1.7 times book values, and at an average dividend yield of 4.3 per cent.

How substantially investors have altered their ideas of stock values over the past year is indicated by comparison of these ratios with those for the stock market low points in 1953 and 1949.

It will be noted, also, that as a result of this new appraisal of values this group of stocks is selling at ratios approaching those at the bull market high points in 1937 and 1946. They are, however, far from those of '29 when the Dow-Jones average, as then constituted, registered 19 times annual earnings, 2.5 times book values, and a dividend yield of 3.3 per cent. The latter was actually less than the yield on prime corporate bonds then around 4.8 per cent.

The Test of Credit

A test of the market from the standpoint of credit involved is indicated by the next chart.

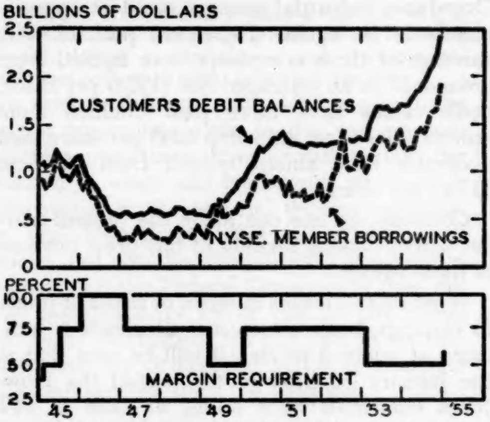
This shows that stock buying on credit, as reported by the New York Stock Exchange, has increased steadily since early last year. Thus at

Dow-Jones Industrial Stock Price Index, Annual Earnings, Year-end Book Value, and Dividends per Share at Selected Dates

Dates	Dow-Jones Price Index	Earnings per Share for Year	Price-Earnings Ratio	Book Value at Year-End	Price-Book Value Ratio	Dividend for Year	Annual Dividend Yield
1929 Peak (Sept.)	381.2	$19.94	19.1	$152.63	2.50	$12.75	3.34
1937 Peak (Mar.)	194.4	11.49	16.9	86.33	2.25	8.78	4.52
1942 Low (Apr.)	92.9	9.22	10.1	109.00	.85	6.40	6.89
1946 Peak (May)	212.5	13.63	15.6	130.23	1.63	7.50	3.53
1949 Low (June)	161.6	23.54	6.9	170.94	.95	12.79	7.91
1953 Low (Sept.)	255.5	27.23	9.4	225.00	1.14	16.11	6.31
1955 Peak (Jan.)	408.9	28.00*	14.6	235.00*	1.74	17.47*	4.27

* 1954

the end of December '54 customers' "net debit balances" (money owed to Stock Exchange firms by customers having margin accounts) reached a total of $2,429 million, up $733 million, or 43 per cent, since December '53.



Stock Exchange Customers' Debit Balances, Member Borrowings, and Margin Requirements

At the same time, bank loans to others than brokers for purchasing securities other than U.S. Governments reached $482 million, up $155 million, or 47 per cent, since the previous December.

While comparable figures for the latter series are not available prior to March '53, figures for the Stock Exchange series show the December '54 debit balances as standing at $1,267 million above the level in 1946 when margin requirements were raised by the Reserve Board to 100 per cent. The latest total is, in fact, the highest since publication of the figures was inaugurated early in '31.

Again, however, it is necessary to keep things in perspective.

While Stock Exchange loans have gone up, so also has the value of listed securities. Granted that the latter is partly a reflection of the former, it is true also that the increase in credit is partly a reflection of the increase in value of listed securities, due to additional listings as well as higher prices.

When account is taken of this growth in listed values we get quite another picture. Measured against the $169 billion of listed shares at the end of December '54, the $2,429 million of customers' debit balances on the same date amounted to only 1.4 per cent. This was precisely the same as a year ago, despite the rise in the debit balances in the meantime, and compares with 1.1 per cent in June '49, 1.0 per cent in May '46, and 2.5 per cent in March '37.

The debit balance figures do not go back to '29, but in September of that year total brokers' loans as reported by the Stock Exchange (ordinarily a lesser figure than customers' debit balances by reason of customers' credit balances) amounted to $8.5 billion, or almost 10 per cent of the total value of listed issues. This compares with $1.9 billion, or 1.1 per cent in December '54.

The Tests Summarized

Taking these two tests together, what the analysis appears to bring out is broadly the following:

1. While current market evaluations, as indicated by the Dow-Jones industrials, appear statistically to be on the optimistic side, when measured by past relationships they do not appear by and large to have gone to extremes.

2. While the volume of stock market credit has expanded sharply with the rise in prices over the past year it is still, over-all, relatively moderate.

3. If concern is warranted it is more over the rate at which stock market prices and stock market credit have been rising than over the actual levels so far attained.

These conclusions appear to be borne out by the moderate character of the Federal Reserve action requiring persons borrowing to buy securities to put up more cash. The fact that the margin boost was only 10 points – from 50 to 60 per cent – has been interpreted more as a warning than as a sign by the Reserve Board of any serious alarm over the stock market situation. While the authorities vouchsafed no official statement, it was explained unofficially that the move was made now "to prevent excessive use of credit in stock buying that might endanger the business recovery." The "Federal" is apparently acting on the old adage that "a stitch in time saves nine."

This is an entirely different story from '29 when the Federal Reserve – lacking then the power to change margin requirements – relied upon general credit controls, including the lifting of Reserve Bank discount rates to 6 per cent. The slight upward shading in open market interest rates recently permitted is a far cry from the high money rates imposed in the effort to curb the speculative excesses of the late '20s.

Question of Intangibles

So far in discussing security values we have been dealing mainly with the statistics. Actually, of course, there is a great deal more to the problem than just statistics.

We referred at the outset to such intangibles as the degree of investor confidence both in the general economic climate and in the prospects for the particular company. It is a truism that stocks sell not so much on the basis of conditions today as on what investors expect them to be tomorrow.

Among the many intangibles entering into current security valuations, the most potent undoubtedly has been growing faith not only in the present upturn in business but also in the long-range growth and prosperity of the country. Another intangible has been the feeling on the part of more people that the long-run trend is towards inflation; hence a tendency to invest in common stocks as a possible hedge against a shrinking dollar.

The answer to the question whether or not stocks are "too high" must obviously depend very greatly upon the validity of such underlying assumptions. Should optimistic appraisals of earnings and dividend prospects prove justified, stocks which look "high" today may turn out to have been very reasonably priced. On the other hand, should the appraisals prove to have been too rosy, the market could be in for a stumble, as has happened before.

Villain in the Piece?

As for the Senatorial study of the market, it remains to be seen whether this is to be a genuine attempt to understand and to inform the public of the forces affecting prices and of the market's place in the economy, or whether this is to be just another fishing expedition on the assumption that there is somewhere a villain in the piece.

Efforts to make the securities and commodities markets whipping boys are an old story. It is not to be denied that at times in the past, under circumstances far different from those prevailing today, there have been indications of deliberate market manipulations that had little relation to real values. But it would be a mistake not to recognize the changed conditions under which the securities exchanges operate today, and unfortunate to drag out the old bogies of a "Wall Street" and a mysterious "they" who are supposed to put prices up or down at will.

Actually, Wall Street reflects the actions of millions of buyers and sellers, large and small, institutional and individual, all over the country and abroad. Data on who are doing the trading, collected by the Stock Exchange from spot checks of actual transactions, are evidence of this diversity; and the country-wide trend of recent years toward liberalization of fiduciary investments is further evidence of a wide acceptance of stocks as investments. According to the survey just announced, members of the Exchange and non-member brokers and dealers do about 24 per cent of the trading on their own account; institutions (banks, insurance companies, investment trusts, etc.) do about 14 per cent; and the general public about 62 per cent. People with annual incomes under $10,000 are as large a factor in the trading as those with incomes over $25,000. Approximately 69 per cent of the non-member trading by individuals originates outside New York City.

There are, however, certain areas in which a serious inquiry can prove helpful if the Committee is really concerned, as stated, in keeping the study objective and constructive. Among these may be suggested the following:

1. More adequate data than are now available as to the volume of buying by institutional investors — investment trusts, corporate pension funds, personal trusts, insurance companies, savings banks, etc. — and its possible effect in locking up stocks more or less permanently and thus diminishing the available supply on the market.

2. The postwar tendency of corporations to finance capital improvements out of earnings rather than by public issues, together with the favorable tax treatment accorded interest on debt, tending to dry up the supply of new stock issues.

3. The capital gains tax which makes investors unwilling to sell and take profits. The deterrent effect becomes compounded in the case of the older investor by the high estate taxes which, when the investor dies, take an additional slice out of his assets.

4. The question as to how far, in view of the fluidity of credit wherever created, it is possible to trace the real sources of funds used in the stock market; also how far it is possible to make money tighter for stock market uses while keeping it easy for everything else.

In some of these areas, the Congress itself has the power to act effectively. One step that might do the maximum good with the least loss of revenue would be reduction or elimination of the tax on capital gains, widely regarded as one of the most important single factors contributing to the thinness of the market. Since the Congress is undertaking to investigate rising stock prices it would seem incumbent upon it to consider carefully its own part in promoting such rise.

HIGHLIGHTS of 1954

from the Annual Report of

The National City Bank of New York

and

City Bank Farmers Trust Company

The end of 1954, the 142nd year since The National City Bank of New York was established, found deposits, total resources and capital funds of the Bank at new highs. These and other highlights of the past year include:

▸Operating earnings, after taxes, totaled $33,766,726 ($3.38 per share on 10,000,000 shares outstanding at the year-end).

▸Operating earnings and security profits together totaled $41,683,401 ($4.17 per share).

▸Taxes and assessments paid or reserved totaled $38,728,000 ($3.87 per share).

▸Total salaries paid here and abroad came to $52,048,000.

▸Dividends paid equaled $2.25 per share. Quarterly payment of 60 cents on November 1 was at an annual rate of $2.40.

▸2,500,000 additional shares of capital stock were sold (effective October 28) for $131,250,000.

▸Capital funds at the year-end totaled $584,700,224 ($58.47 per share on 10,000,000 shares) compared with $424,755,970 ($56.63 on 7,500,000 shares) a year earlier.

▸Total resources of the Bank increased to $6,323,000,000 and deposits to $5,639,000,000.

For copy of complete Annual Report, write the Public Relations Department, The National City Bank of New York, 55 Wall Street, New York 15, New York.

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